Fund Finance

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British Virgin Islands

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Overview

The British Virgin Islands is the global market leader in offshore corporate structures, with an estimated 36% global market share of active offshore companies registered within the jurisdiction, easily dwarfing its nearest competitors. But notwithstanding its dominance in the wider market for offshore corporate vehicles, the British Virgin Islands remains something of a niche player in offshore investment funds.

In the most recent statistical bulletin from the Finance Services Commission (which is the regulator with supervisory jurisdiction over investment funds in the Territory), the British Virgin Islands had a total of just over 1,500 investment funds (as at Q1 2018). The estimated assets under management held in regulated BVI fund structures is reported to be approximately US$345 billion. Those figures are robust when compared to some other financial centres like Jersey and Guernsey, but relatively small when compared against the regional market leader, the Cayman Islands, which boasts 10,559 licensed funds (as of 2017), and an estimated U$1,482 billion AUM. However, that picture is potentially slightly misleading.

The British Virgin Islands investment funds industry is heavily focused upon open-ended funds with lower capitalisation, and particularly start-ups, due to the Territory's reputation as a cost-efficient jurisdiction. The number and value of closed-ended / private equity capital funds is difficult to quantify as these typically fall outside of the regulatory regime, and there are not statistics which capture this data. Based on collective market information and deal flow, however, British Virgin Islands structures for private equity and real estate investments are thought to significantly outweigh the number and value of open-ended regulated funds.

Fund formation and finance

The British Virgin Islands is a popular domicile for a variety of different types of collective investment schemes including hedge funds, funds of funds and private equity funds. It is widely recognised as the second-most popular offshore domicile for open-ended investment funds after the Cayman Islands. The primary legislation which governs collective investment schemes in the British Virgin Islands is the Securities and Investment Business Act 2010. British Virgin Islands law distinguishes between mutual funds (as defined), which are subject to statutory regime, and other types of collective investment schemes which escape any form of direct regulation. To fall within the regime, a fund must issue "fund interests", which are defined as "rights or interests, however described, of the investors in a mutual fund with regard to the property of the fund, but does not include a debt", and the fund interests must generally be redeemable at the election of the holder.

Structures

Broadly, there are three primary vehicles used in the British Virgin Islands in relation to fund activity: companies; limited partnerships; and unit trusts. The most popular are companies, and unit trust structures are the least common. This contrasts with the Cayman Islands, where a significantly larger proportion of investment funds (which includes unregistered funds) are formed as limited partnerships. With a number of changes introduced into the British Virgin Islands by the Limited Partnership Act 2017 (considered further below), the use of limited partnerships, particularly in relation to private equity and financing structures, is expected to increase significantly. Unit trusts usually have a regulated BVI company as trustee, but the redeemable fund interests are units under the trust.

The most common structures for BVI funds are:

- Single-class funds which are set up with a single class of shares, giving investors the opportunity to participate in a single investment portfolio.
- Multi-class funds (commonly referred to as "umbrella funds"), which issue equity interests in a number of different classes to enable investors to participate in a range of investment portfolios. To deal with this issue, multi-class funds can be incorporated in the British Virgin Islands as segregated portfolio companies, under which the assets attributable to a particular portfolio are segregated by statute and not available to meet the liabilities of creditors attributable to any other portfolio.
- Master/feeder funds, which are structured to enable subscriptions made in separate "feeder vehicles", to be pooled into and managed as a single master fund portfolio. The principal objective is to enable investors that are subject to differing tax or other regulations, or with distinct requirements, to participate together in the same investment portfolio having common investment objectives. The structure achieves economies of scale for portfolio-related activities.
- Single investor funds are widely used by institutions, funds of funds and high-net-worth individuals as an alternative to managed accounts solutions. By establishing a fund, investors maintain the flexibility and limited liability of a corporate vehicle, which can engage its own service providers.

Licensing regimes

From the perspective of debt financing, the relevant regulatory structure utilised by the investment fund will rarely be a material issue. However, for completeness, the regulatory structure in relation to BVI investment funds can be summarised quickly. There are three categories of regulated investment funds, and then two further classes of funds which are either registered or recognised. Outside of that lies a significant further body of unregulated, closed-ended investment vehicles.

- **Private funds**. A private fund is restricted to either: (a) having no more than 50 investors; or (b) only making an invitation to subscribe for or purchase fund interests on a private basis.
- **Professional funds**. A professional fund is a fund the shares in which are only made available to "professional investors", and the minimum initial investment by each professional investor (other than exempted investors) is not less than US$100,000 (or other currency equivalent).
- **Public funds**. A public fund is a fund that qualifies as neither a private fund nor a professional fund. It is generally viewed as a retail product and accordingly, the regulatory burden is considerably higher.

- **Incubator funds**. Under Guidelines issued by the regulator, the purpose of incubator funds is to "provide more flexibility to smaller and start-up financial services businesses". An incubator fund is not regulated, but must nonetheless still be approved by the Financial Services Commission. The fund must fall within certain criteria relating to the size and sophistication of investors, and the fund may only operate as an incubator fund for a maximum period (normally two years).
- **Approved funds**. Similar to incubator funds, approved funds are aimed at smaller, start-up funds with lower capitalisation, and for similar reasons are not regulated but must be approved by the Commission. They have similar thresholds, although they may be larger in terms of AUM, but an approved fund must have an independent fund administrator, and the period of time under which it can operate as an unregulated approved fund is not restricted.

Financing and security

Utilisation of debt finance as part of a leveraged investment strategy is relatively common in the British Virgin Islands, and the popularity and use of British Virgin Islands vehicles for subscription finance is growing, particularly where law firms leverage knowledge and experience built on the Cayman subscription finance model.

The British Virgin Islands legal system is accommodating and flexible in relation to borrowing and debt issuance. There are no regulatory approvals or filings which are required in relation to borrowing by funds (subject to the registration of security interests, which we consider below). Foreign financial institutions do not need to be licensed or regulated in the British Virgin Islands to advance loans to British Virgin Islands funds. There are no generally applicable legal limits or restrictions on borrowing, thin capitalisation or interest limitation laws. Further, under British Virgin Islands law, "lender liability" (meaning liability to the borrower for an institution improperly or imprudently advancing the loan) is not recognised.

Secured lending transactions in relation to British Virgin Islands investment funds typically involve the granting of security over financial assets held by the fund or a third-party guarantor. Generally speaking, granting of security interests to support primary borrowing, or guaranteeing obligations, are fairly routine and unremarkable in the British Virgin Islands. However, two specific asset classes do call for some further considering, *viz*., where the fund grants security over shares or other securities issued by subsidiary British Virgin Islands companies or partnerships (as may happen in a fund of funds or master feeder structure), and funds subscription finance where security is granted over future capital calls.

British Virgin Islands securities. Security over underlying equity rights in British Virgin Islands entities can be divided into two broad categories. Where the securities are deposited with a custodian or other intermediary, then under British Virgin Islands law that is broadly treated as a security interest over the relevant account rights, and will normally be documented under a foreign law (the law of the place of the custodian) and for the most part is unproblematic, and will typically be backstopped by an account or control agreement with the custodian. Where the securities are not so held, and are instead charged or pledged directly, then care needs to be taken when drafting security documentation to accommodate provisions under British Virgin Islands law relating to enforcement periods. The parties may also wish to consider taking additional steps to record the security in the register of members or register of partnership interests, and/or putting side letters or similar arrangements in place with the registered agent or transfer agent to ensure that in the event of enforcement, the secured creditor has a direct legal nexus with that party.

Subscription finance. Funds subscription finance, also known as capital call or equity bridge finance, are loans to a fund secured on the undrawn commitments of the fund's limited partners to make capital contributions to the fund (when called upon to do so by the fund's general partner). Uncalled capital commitments may also be used to secure related funds' transactions such as hedging, so as to reduce the fees being paid by the fund. The popularity of subscription finance transactions relates to a number of key benefits:

1. **Reduced costs**. It allows the fund to benefit from guarantees from its investors, without the investors having to give a guarantee or expose themselves to any additional liability than their existing uncalled capital commitments in the fund.
2. **Ease of administration**. Instead of funding an investment by making capital calls directly to its investors (which if the fund's investors are feeder funds, will involve those investors making calls on their own investors), the fund can make a single drawdown on the subscription facility instead. The fund can then make its call on its investors and use those proceeds to repay the lender.
3. **Increased returns**. As the investors' monies are only called when they are needed, they generate a higher return on investment in relation to capital actually deployed.
4. **Flexibility**. In terms of credit analysis, the subscription finance lender is only reviewing the investors sitting above the fund; it does not compete with any other lender who would be conducting credit analysis on the fund itself and the assets owned by the fund. A traditional bridge lender who was secured by all-asset security over the fund's assets would require a release of that security whenever the fund refinanced specific investments.
5. **Simplicity**. Subscription finance should be straightforward to document: there should be no covenants tied to specific assets, or restrictions on how the fund uses the borrowed monies.

Under British Virgin Islands law, capital call rights are receivables (or future receivables) which have their situs in the British Virgin Islands. Under British Virgin Islands law, unless the secured creditor gives notice to a third-party payor (i.e. the investor), then the investor can obtain a good discharge by payment to the original obligee (i.e. the fund). In practice, many funds will negotiate that no notice be given to investors unless or until a default or potential event of default has occurred, but legal risk can be mitigated by proper registration of the security interest (as to which, see below), which will provide constructive notice of the assignment to the entire world.

Registration and perfection of security

Where an investment fund (whether regulated or unregulated), which has been formed as a company or a limited partnership registered under the 2017 Act, grants any security over any of the assets of the fund (including call rights), that security interest is capable of being registered in a public register of registered charges maintained by the Registrar of Corporate Affairs in the British Virgin Islands. The regime applies broadly to all security interests created by the fund – whether the security is fixed or floating, whether the governing law of the security interest is British Virgin Islands law or the laws of a foreign jurisdiction, and regardless of where in the world the collateral is located.

Registration has two key benefits for the secured party. Firstly, in the event of two or more security interests being created over the same collateral, the British Virgin Islands courts will treat the security interest registered first in time as having the first priority between competing encumbrances. Secondly, registration of a security interest is treated as

constructive notice of the existence of the security interest to the entire world, precluding the risk that a *bona fide* purchaser for value without notice might be able to overreach the security interest and take clear title.

The registration process in the British Virgin Islands also permits the secured party to record the existence of a negative pledge in the security documents. This not only puts third parties on notice of the existence of the restriction, but it can also affect the priority of a subsequent security interest created in breach of the registered restriction. Conversely, the impact of any failure to register a security interest is less dramatic than in many other common law jurisdictions. Failure to register a security interest will not negate the validity, legality, enforceability or admissibility in evidence of the relevant security interest. The main disadvantages are the corollaries of the advantages – an unregistered security may be at risk of losing priority if a subsequent charge is created over the same assets and registered ahead of the original security interest, and third parties dealing with the collateral in good faith may not have notice of the relevant security interest.

Where security is granted over interests in the fund (such as commonly happens in a fund of funds structure which employs leverage with respect to certain classes of investor), there are additional steps which can be taken with respect to making notations on the register of members or register of limited partnership interests, but these steps neither constitute perfection nor relate to priority.

Under British Virgin Islands law, registration of security is not necessary to "perfect" the security interest in the sense of either attaching the security interest to the collateral, or ensuring that the security interest is enforceable against third parties or a liquidator in an insolvency or bankruptcy. However, there may be jurisdictions where the collateral is located overseas which regard registration in the British Virgin Islands (as the corporate seat of the chargor) as being relevant to perfection of the security interest under those foreign laws. For example, perfection of a charge under New York law by a British Virgin Islands chargor may be satisfied by making a relevant filing in the British Virgin Islands instead of filing a UCC-1.

The position with respect to unit trusts is more complex. Under the relevant legislation, a trust instrument constituting a unit trust may make provision for trustee statutory charges, which introduces a statutory priority scheme similar to that of companies and limited partnerships for trust structures. In practice, however, the use of trustee statutory charges is still uncommon, and may reflect the general reticence in relation to unit trust structures within the jurisdiction.

Priority and enforcement of security

Priority of security interests created by investment funds over their assets is normally determined by the order of registration in the British Virgin Islands. Issues relating to priority, where two or more charges are created over the same collateral and both remain unregistered, are complex. Generally speaking, the first in time normally prevails, but there are special rules which regulate priority as between fixed and floating security interests, and special rules relating to receivables and the order in which notice is given to the debtor (the infamous rule in *Dearle v Hall* (1828) 3 Russ 1).

Enforcement of security interests varies according to the governing law of the security interest and law of the place where the relevant collateral is located. Typically for collateral which takes the form of financial assets (the most common situation in fund financing), enforcement is by way of exercise of power of sale. Where the security interest is governed by British Virgin Islands law, the secured party is generally under a duty to sell for the best

price reasonably obtainable, but there is considerable leeway given in relation to the timing and mode of sale, as well as tacit recognition that there may be pressure on the price of assets sold on a distressed basis. Generally speaking, British Virgin Islands law and the British Virgin Islands courts are fairly comfortable with foreign law security interests, and recognise that rules and duties around the enforcement of such security interests may be quite different from (or even completely unknown to) British Virgin Islands law (see, for example, *Cukurova Finance v Alfa Telecom Turkey* [2009] UKPC 19).

Insolvency and netting

Under British Virgin Islands insolvency law, the power of a secured creditor to enforce a security interest against a British Virgin Islands fund is not generally affected by any insolvency process; security rights remain enforceable against the underlying collateral in a bankruptcy process. Where the BVI fund has entered into netting arrangements in relation to financial contracts (for example, under a standard form ISDA Master Agreement or similar arrangement) the right to net is protected under ISDA model netting laws, which have been incorporated into the British Virgin Islands insolvency regime. Those model laws include protection of any security rights in relation to the netting arrangement, and the model law provides that those netting rights will prevail over any rule or law relating to insolvency in the British Virgin Islands.

Key developments

There have been a couple of key legal developments recently in relation to fund financing structures in the British Virgin Islands.

Limited Partnership Act 2017

Prior to 2017 all limited partnership structures in the British Virgin Islands were regulated under the Partnership Act 1996, and in British Virgin Islands Commercial Law (3rd ed.) were memorably referred to as being the "ugly stepsister" of British Virgin Islands law. On 11 January 2017, the Limited Partnership Act 2017 came into force, which was the culmination of a number of industry-driven initiatives to create a limited partnership structure which was optimised for investment funds, and a number of the modifications were made with particular reference to leverage and secured financing. Relevant changes under the new legislation included:

- Separate legal personality for limited partnerships – a key differentiator in relation to the principal competitor jurisdictions to the British Virgin Islands.
- Registration regime in relation to security created over partnership assets.
- Priority regime in relation to security created over partnership assets.
- Simplified netting and set-off rights with respect to partnership structures.
- Extension of protections for secured creditor's rights in relation to insolvency and bankruptcy.
- Introduction of voluntary restructuring regimes for limited partnership structures.

Limited partnerships which were registered under older legislation have the option to re-register under the 2017 Act to take advantage of the new provisions.

These changes, taken together, are intended to make British Virgin Islands limited partnership structures considerably more attractive with respect to private equity and debt financing structures, and to remove a number of the previous uncertainties which existed under British Virgin Islands law in relation to financing partnership structures.

Segregated Portfolio Companies (Mutual Funds) Regulations 2018

Prior to 2018, the ability to use segregated portfolio companies (also referred to in some countries as protected cell companies) was restricted to a limited number of types of regulated business. With effect from 1 October 2018, the scope for using SPCs was significantly increased pursuant to three related statutory instruments, the most relevant of which was the Segregated Portfolio Companies (Mutual Funds) Regulations 2018. Under those regulations, the categories of companies which may utilise the segregated portfolio structure are widened, and include both incubator funds and approved funds.

The year ahead

2017 in particular was a period of rapid evolution for fund structuring in the British Virgin Islands. Although a number of those legal reforms are still bedding in, further reform appears likely looking ahead to 2019. Consultation with the private sector has been undertaken in relation to bringing in new LLC structures to facilitate the North American market.

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In addition to his role as managing partner of the BVI office, Colin Riegels serves as the Global Head of our Banking and Finance practice and advises on a wide range of credit and security issues. His client base largely consists of leading financial institutions.

Before joining us, Colin practised as a barrister in London. He served as a judicial assistant to Lord Woolf MR in the English Court of Appeal, and taught law at Oxford University. Currently, his practice primarily revolves around insolvency and distressed debt, credit and security issues and derivatives. Additionally, Colin advises clients on offshore structuring and offshore premium corporate transactions. He has worked on some of the largest financing transactions involving BVI vehicles, including a number of multi-billion US dollar debt financing transactions and joint ventures.

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Nadia Menezes is counsel in our British Virgin Islands office. Her practice encompasses offshore investment funds, regulatory and corporate and finance law.

Prior to joining us in 2017, Nadia was counsel at Appleby and previously worked at Ogier. Before moving offshore, Nadia worked at Mayer Brown LLP in London and Brussels as a corporate lawyer. She has significant experience advising upon the formation and regulation of hedge funds, real estate and private equity funds. She also provides clients with ongoing advice on restructuring solutions and dealing with regulatory compliance. Nadia has a broad range of experience in corporate, commercial and securities offering transactions for both private and publicly quoted companies. In addition to her mainstream corporate and funds experience, Nadia has substantial experience in advising companies active in the telecommunications sector.

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